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C O N F I D E N T I A L SECTION 01 OF 02 DUBLIN 000156

SIPDIS

TREASURY FOR ATUKORALA

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SUBJECT: IRISH GOVERNMENT'S BUDGET -- POLITICS TRUMPS
ECONOMICS

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Classified By: PEO Chief Ted Pierce. Reasons 1.4(b/d).

¶1. (C) Summary: On April 7 the Irish government released a supplementary budget in response to the dramatic deterioration in the government's finances. Despite pre-budget calls for a focus on spending cuts (ref A), the government's budget is weighted toward tax increases, such as a doubling of the income levy (ref B). The Finance Minister also announced plans to create a government agency that will oversee the disposal of "troubled" assets on Irish banks' books. The tax increases will do nothing for consumer confidence and may serve to prolong the economic downturn. The government already expects to face an attack by the political opposition. It did not have the political will to face down the unions and others who opposed spending cuts. At some point, however, the government will need to do something about the outsized public-sector pay bill and welfare entitlements. End Summary

¶2. (U) On April 7, Finance Minister Brian Lenihan announced the government's supplementary budget designed to help rectify the government's poor fiscal situation. Significantly, the government outlined a three-year plan to reach a budget deficit of 8.5 percent of GDP in 2011 (the pre-budget figure is just under 13 percent). The package of measures is projected to shrink the government's 2009 deficit by EUR 3.3 billion (USD 5 billion) but the deficit will still be about 10.75 percent of GDP. The package is weighted in favor of tax increases over spending cuts (55 percent to 45 percent), in spite of the fact that most economists highlighted the need for more action on the spending than the revenue side. Taxes will still make up a majority of the 2010 package but spending cuts will be in the majority in
¶2011.

¶3. (U) The government expects the economy to contract by eight percent in 2009 (private economists suspect it will be higher) and almost three percent in 2010. Prices are estimated to fall (deflation) by almost four percent this year and unemployment will rise to an average rate of 12.6 percent in 2009 on its way to 15.5 percent in 2010.

Revenues

¶4. (U) The government expects to raise EUR 1.8 billion (USD 2.6 billion) from tax increases in 2009. The biggest moneymakers will be the doubling of both the income levy (introduced in October 2008) and the health levy. According to Ulster Bank, the changes in these levies will reduce

take-home pay for households earning between EUR 50,000 (USD 70,000) and EUR 100,000 (USD 140,000) by four to six percent. Other measures include an increase in the capital gains tax; mortgage interest relief to be reduced and later abolished; an increase in excise taxes on cigarettes; and an increase in deposit interest tax.

Expenditures

¶5. (U) Spending cuts will amount to about EUR 1.5 billion (USD 2.2 billion). The government only lightly touched public-sector pay (one-third of overall spending) and social welfare benefits (40 percent of spending). The budget introduces an early retirement scheme for public-sector employees that should induce many employees to leave voluntarily. In addition, the under-20 job seeker's allowance will be halved and Christmas bonus payments will be eliminated in 2009. Capital expenditures will fall by EUR 576 million (USD 880 million), mainly in transport, social housing, and water projects, and will be cut by EUR 1.3 billion (USD 1.9 billion) in 2010 and EUR 2.4 billion (USD 3.5 billion) in 2011.

The "Bad Bank"

¶6. (U) Minister Lenihan also announced the establishment of the National Asset Management Agency (NAMA) which will deal with "distressed" land and property development assets held by Irish banks. The details of the plan are still being worked out but the idea is to have NAMA buy the loans from the banks at an "appropriate price." Because these loans will be transferred at a discount to book value (currently EUR 80-90 billion/USD 115-130 billion), the banks will incur

a loss on these transfers. In order to avoid a further recapitalization of the banks because of this, these loans will be replaced on the banks' books by zero-risk-weighted government bonds, thus reducing the overall risk weighting of the banks' assets. We will follow this plan quite closely as more details become available.

¶7. (C) On April 7, Econoff spoke with Kevin Cardiff (protect), Second Secretary General at the Department of Finance, who said that the pricing of assets should be finished within three months. Cardiff said he will need about 30 more staff members, who will come in on a contract basis, to set up NAMA and value the banks' assets. He hinted that, given the work he and his colleagues have already done, the assets will be discounted by around 50 percent. He also said that, while this program is modeled on the Resolution Trust Corporation that was put in place following the savings and loan collapse in the U.S. in the late 1980s, NAMA "will be in no hurry to dispose of the assets." Cardiff said that they could and would hold the assets for "a decade or more if it took that long to get the right price."

Comment

¶8. (C) Despite much post-budget hand-wringing by economists here about the preponderance of tax increases in the plan, the government clearly did not have the will to take on (again) the trade unions and others who were pushing for higher taxes instead of spending cuts. This political decision, though, could have serious economic repercussions. With significantly lower take home pay (and even less next year), consumer confidence may not rebound so consumers will continue to keep their wallets shut. The government seems to want to buy time -- maybe waiting until the June local and European elections and the October re-run of the Lisbon Treaty referendum are over -- before it takes on the unavoidable challenge of cutting public sector pay and welfare entitlements.